No. 15370

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MULTNOMAH OPERATING COMPANY, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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INDEX

CITATIONS

Cases:

Statutes:

Miscellaneous:

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 25-48) are not officially reported.

JURISDICTION

The Commissioner's petition for review involves deficiencies in income taxes determined and asserted against the taxpayer in the sums of $11,805.43 and $11,530.56, aggregating $23,335.99, for the taxable years 1948-1949 (R. 8-12, 25), and redetermined by the Tax Court in the sums of $405.43 and $130.56, aggregating $535.99, for those years, respectively (R. 54). On December 15, 1953, the Commissioner mailed a statutory notice of such deficiencies to the taxpayer. (R.

8-12.) Within ninety days and on March 3, 1954, the taxpayer, pursuant to Section 272 of the Internal Revenue Code of 1939, filed a petition in the Tax Court for a redetermination of those deficiencies. (R. 3, 5-12.) On February 23, 1956, the Tax Court filed its memorandum findings of fact and opinion (R. 4, 25-48), and on March 21, 1956, the Commissioner filed a motion and also an amendment thereto to vacate and review the Tax Court's opinion by the full Court, both of which were denied on March 22, 1956 (R. 4, 49-53). The decision of the Tax Court was entered on June 14, 1956. (R. 54.)[1] On September 5, 1956, the Commissioner filed a petition for review invoking the jurisdiction of this Court under Section 7482 of the Internal Revenue Code of 1954. (R. 4, 55-56.)

QUESTIONS PRESENTED

1. Whether the Tax Court improperly decided the case on a ground not in issue and in respect of which the Commissioner was given no opportunity to present evidence or argument.

2. Whether the monthy and/or quarterly payments made by the taxpayer to its three controlling stockholders, under an agreement entered into contemporaneously with a lease-extension agreement obtained in 1944 by the taxpayer, represented deductible compensation for services rendered by them during the taxable years involved, within the meaning of Section 23(a)(1)(A) of the Internal Revenue Code of 1939, as held by the Tax Court, or distributions in the nature of

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[1] The docket entries indicate that the decision was entered on June 13, 1956. (R. 4.)

guaranteed annual dividends to such stockholders in proportion to their stockholdings in the taxpayer, as determined and contended by the Commissioner.

3. If the payments in question actually represented compensation for services rendered by the controlling stockholders during the taxable years, whether they are shown by the record to have constituted reasonable compensation allowable as deductions under the statute.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or Business Expenses.*

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *

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(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the

case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. * * *

* * * * *

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

STATEMENT

The facts as found by the Tax Court (R. 25-45), including the stipulated facts (R. 14-24) which were found and adopted by the Tax Court as stipulated (R. 25), may be summarized and restated sufficiently for present purposes substantially as follows:

The taxpayer, Multnomah Operating Company, is a corporation with its principal office and place of business in Seattle, Washington. It filed income tax returns for the calendar years 1948 and 1949 with the collector for the district of Washington. (R. 25.)

The taxpayer was incorporated in 1931 with a paid-in capital of $1,000 which was represented by 250 shares

of common stock.[2] (R. 25.) On July 1, 1931, the taxpayer's stock was owned 50% by Maltby-Thurston Hotels, Inc. (hereafter called the Maltby), 25% by the Pacific Coast Investment Company (hereafter called PCI), and the remaining 25% was owned 7% by Frank A. Dupar and 18% by others who were apparently associated with him. (R. 26.)[3]

During the period 1944 through 1949 the voting control of taxpayer rested in the members of a voting trust, the identity and stock contributions to the trust of such members being as follows (R. 26):

Multnomah Operating Co.

Members of Voting Trust from May 1, 1940, to May 1, 1950

	1944	1948	1949
F. A. Dupar	17	17	17
H. E. Dupar	15	—	—
Maltby-Thurston Hotels, Inc.	124	124	124
Pacific Coast Investment Co.	61½	61½	61½
Seattle First National Bank, Trustee under Will of H. E. Dupar, deceased	—	15	15
Total	217½	217½	217½

[2] These shares were held on July 1, 1931, and January, 1944, 1948 and 1949 by the several shareholders as listed in the Tax Court's findings of fact (R. 25-26), and therefore such holdings are not duplicated here.

[3] The Tax Court found that Frank A. Dupar owned 17 shares, H. E. Dupar (his brother) owned 15 shares, and A. F. Bassett and A. D. Berlanger each owned 15 shares. (R. 26, 100-101.) The record shows, moreover, that Frank A. Dupar had joint ownership in Berlanger's 15 shares and had acted as proxy for Bassett's 15 shares. (R. 116-117.)

The Multnomah voting trust stock was votable by S. W. Thurston, Frank Dupar and F. M. Kenney on behalf of PCI in that order conditioned upon whether he who had the primary right so to do died, became incapacitated, unwilling or unable to vote the stock. The Maltby voting trustees in 1948 and 1949 were H. E. Maltby, S. W. Thurston, T. E. Himmelman, Frank A. Dupar and F. M. Kenney. (R. 40.)

Western Hotels, Inc. (hereinafter called Western), was incorporated about 1930 as a hotel service organization rendering general services to all hotels for a consideration. Its total capital stock during 1931 consisted of 5,630 shares, which was reduced to 100 shares in 1934, and on July 1, 1931, and January 1944, and 1948 and 1949, was owned 50% by Maltby, 25% by PCI, and 25% by Frank A. Dupar. (R. 28-29, 98.) [4] The organization of Western represented an effort on the part of Maltby, PCI and Frank A. Dupar, who had previously been competitors, to thereafter cease competition and act in concert to their mutual benefit in the hotel business. (R. 28.)

By a lease, dated June 17, 1931, negotiated at arm's length, Hauser Securities Company leased the Mult-

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[4] This is not apparent from the Tax Court's findings (R. 28-29) or the stipulation of facts (R. 15), in both of which stock ownership in Western is listed. However, the listed stockholders other than Maltby, PCI or Frank A. Dupar apparently represented the stock ownership of those three for Frank A. Dupar testified (R. 98) that Western's stock was owned 50% by Maltby, 25% by PCI, and 25% by himself. All the shareholders of Western as of July 1, 1931, and January 1944, 1948 and 1949, are listed in the Tax Court's findings (R. 29), as they are for PCI as of those dates (R. 29-33); hence, they are not reprinted here. Also, the officers and directors of Western and PCI, as well as of the taxpayer and Maltby, for all times material are listed in the Tax Court's findings (R. 33-40), as stipulated by the parties (R. 18-23), and therefore they are not repeated here.

nomah Hotel in Portland, Oregon, to Maltby for a term of 15 years commencing July 1, 1931, and ending July 1, 1946. The lease (Ex. 1, R. 68-77) provided, among other things, as follows (R. 40-41):

> This lease to a large extent is based upon the personnel of the present officers of said Lessee [Maltby] and their ability to conduct and operate a first-class hotel and by reason thereof Lessee covenants and agrees not to assign this lease nor sublet nor underlet nor permit any other person or persons to occupy said premises other than the employees and patrons of said Lessee without the consent of said Lessor being first obtained in writing. * * * (Provided further that it is understood and agreed that the within Lessee contemplates the forming of an Oregon corporation [the taxpayer] to whom the within lease may be assigned by it, the majority of the personnel of which will be the same as that of the within named Lessee and/or Western Hotels, Inc., and Lessor consents to the within named Lessee assigning the within lease to said corporation to be duly formed providing that said assignment shall be subject to all of the terms, covenants and conditions of the within lease and with the consent that the demised premises are only to be used for the purposes herein stated and that the within consent shall in nowise alter, change or modify any term, covenant, provision or condition hereof nor shall this consent be continuing or extended to any other person, firm or corporation; provided further that said assignee shall in a form entirely satisfactory to the within named Lessor

> accept said assignment and agree to be bound by all the terms, covenants and conditions of the within lease; that this consent of assignment is limited to the one assignment herein stated, and after such assignment all liability of the within Lessee shall be at an end.

The lease rental consisted of a minimum fixed monthly rental of $7,000 per month and a designated percentage of gross revenue. No bonus or consideration other than this rental was paid to the lessor. (R. 40.)

The lessor required the deposit of security for the performance by taxpayer of the lease provisions. To that end Maltby issued to taxpayer $75,000 of its preferred stock which taxpayer agreed to purchase. The taxpayer in turn deposited the stock as security with the lessor. PCI, through its trustee, Peter G. Schmidt, and Frank Dupar each guaranteeed to Maltby in writing that taxpayer would pay the par value of 25% of such stock. Each was required at an undisclosed time to pay the amount so guaranteed for which payment each was subsequently reimbursed by taxpayer. (R. 41-42.)

On June 30, 1931, Maltby assigned its interests as lessee to taxpayer, such assignment being assented to by the lessor.[5] The assignment was therein stated to be "For One Dollar ($1.00) and other good and valuable consideration." (R. 42.)

The lease had been in negotiation for a period of approximately 10 months prior to its execution on June

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[5] The record shows that Maltby was at all times material a holding company and was never intended to operate the hotel; it was always intended by the parties that the new corporation, the taxpayer, would be the operating company. (R. 102, 117.)

17, 1931. The negotiators had been Dupar, Peter Schmidt and S. W. Thurston, who met with Hauser for negotiation approximately 20 times. At the time of assignment of the lease to taxpayer on June 30, 1931, Frank A. Dupar insisted upon compensation for his services rendered in the negotiations for the lease, for his guarantee of payment of par value of 25% of the Maltby stock placed with the lessor as security by taxpayer, and for what he alleged was his interest in the lease. It was agreed between Maltby, PCI and Dupar that taxpayer would pay to them for the assignment of the lease of the hotel premises the amount of $2,500 per month, or $30,000 a year, after payment of the fixed and percentage rentals required by the lease terms. Of this amount, Dupar insisted that he receive $625 per month, or $7,500 a year, as such compensation. The remainder ($1,875 a month, or $22,500 annually), it was agreed, would be divided between PCI and Maltby in proportion to their respective stockholdings in taxpayer. These payments were provided for by a separate written agreement between taxpayer and Maltby entered into simultaneously with the assignment of the lease. Except for an undisclosed but short period of time immediately following inception, these payments have been made throughout the term of the lease and the extension thereof. (R. 42-43.)

At the time the lease was executed the Multnomah Hotel was in bad repair, and it was apparent that large expenditures would be required in order to make it a profitable business asset. To that end the lease required the expenditure by taxpayer of $21,600 per year over and above all other amounts or that such portion of that amount not so spent be paid to the lessor. (R. 43.)

The original lease terminated by its provisions on July 1, 1946, but an extension was sought by taxpayer as early as 1940 when it became apparent that negotiations by others were in progress in Portland looking toward the construction of a new hotel. Without the expenditure of about $400,000 for reequipment, remodeling and redecorating, taxpayer's hotel could not withstand the competition of a new hotel. Before making such an investment therefore, taxpayer desired an extension of its lease. Negotiations for the taxpayer's lease extension were carried on by S. W. Thurston and Dupar, Schmidt having taken no part therein. Ultimately an extension agreement (Ex. 3, R. 81-86) was executed directly between taxpayer and the owner of the hotel property. This agreement, dated February 4, 1944, extended the term of the original lease to July 1, 1961, and provided for an increase of the minimum fixed rental to $8,500 per month. (R. 83.) All of the terms and conditions of the original lease remained in full force and effect under the extension agreement, including the provision that the officers and personnel of taxpayer were to be the same as Maltby or Western. Simultaneously taxpayer and Hauser entered into a separate written agreement (Ex. 4, R. 87-91) whereby provision was made for replacement of the original security of $75,000 of Maltby preferred stock with a like amount of the common stock of that corporation, which was to be forfeited to Hauser as liquidated damages in case of taxpayer's default in the lease terms. This was stock purchased and owned by taxpayer. (R. 43-44.)

By an agreement between Maltby and Western, as first parties, and taxpayer as second party, dated Feb-

ruary 3, 1944 (Ex. 5, R. 92-97), the taxpayer agreed to continue the payments to Frank Dupar, Maltby and PCI at the rate of $625, $1,250 and $625 a month, respectively, aggregating $30,000 annually, throughout the extended term of taxpayer's lease to July 1, 1961, inclusive. The consideration therein stated for such extension of the payments was the agreement of those payees to accede to the lease extension at a higher minimum rental before the expiration of the original lease, the agreement of Maltby that its officers and personnel or that of Western would continue to operate the Multnomah Hotel, and the services of Maltby, Western and Frank Dupar in securing through negotiation the lease extension agreement. Peter G. Schmidt, as trustee of PCI, did not in fact aid in the procurement of the extension agreement. However, he and Dupar each approved the last mentioned agreement by their signatures. (R. 44-45.)

On the basis of these facts, the Tax Court, rejecting the Commissioner's determination (R. 8-12) and ignoring the only issue—that the payments in question were deductible under Section 23(a)(1)(A) of the 1939 Code "for rent paid" during the taxable years—as pleaded and argued by the taxpayer (R. 6-7, 45), held that the payments were not "rentals' (R. 46); rather, on its own initiative, it held them to be deductible as "compensation for services rendered [by the taxpayer's three controlling stockholders] in the ordinary course of petitioner's business within the meaning of section 23 (a)(1)(A)" (R. 47-48). In view of this inconsistency, a motion to vacate and review the Tax Court's opinion by the full Court pursuant to Section 7460(b) of the Internal Revenue Code of 1954, and an amendment

thereto, were timely filed by the Commissioner, both of which were denied by the Tax Court forthwith. (R. 49-53.) The Tax Court thereupon entered its decision in favor of the taxpayer accordingly (R. 54), from which the Commissioner petitioned this Court for review (R. 55).

STATEMENT OF POINTS TO BE URGED

The Tax Court erred (R. 57-58)—

1. In basing its decision on an issue which was not framed by the pleadings, hearings and briefs, and without affording the Commissioner an opportunity to present evidence on the new issue or even to brief it.

2. In holding that the $2,500 monthly payments in question were compensation for services rendered in the ordinary course of taxpayer's business within the meaning of Section 23 (a)(1)(A); that such compensation is not unreasonable; and that therefore the payments in question were deductible by the taxpayer.

3. In failing to uphold the determination of the Commissioner that the payments in question represented distributions of profits in the nature of dividends and therefore were not deductible by taxpayer.

4. In holding that the basis for the payments was services rendered by the three payees prior to the execution of the original lease in 1931 and also prior to the execution of the renewal agreement in 1944 and for services to be rendered thereafter during the term of the lease and its renewal.

5. In denying the Commissioner's motion, and amendment to motion, to vacate and review opinion by full Court pursuant to Section 7460(b), Internal Revenue Code of 1954.

6. In holding that there are deficiencies in income tax for 1948 and 1949 in the respective amounts of $405.43 and $130.56; and in failing to uphold the deficiencies of $11,805.43 and $11,530.56, respectively, as determined by the Commissioner.

7. In that its opinion and decision are contrary to law and Regulations and are not supported by its findings of fact or substantial evidence.

SUMMARY OF ARGUMENT

1. The Tax Court, on its own initiative, decided this case on the basis of a new issue injected by it which was neither pleaded nor argued by the taxpayer, and in respect of which the Commissioner, taken by surprise, was afforded no opportunity to present evidence and argument. The Tax Court therefore erred in denying the Commissioner's motion, and amendment thereto, to vacate and review its opinion by the full Court, and thereby precluding the Commissioner's presenting evidence on the newly-injected issue. Moreover, since the Tax Court's decision is unsupported by the evidence and therefore is clearly erroneous, it should be reversed by this Court in favor of the Commissioner upon the present record which supports the Commissioner's position taken in the Tax Court. If, however, this Court should not agree with out view that the evidence of record is thus conclusive, we submit that the case should, at a minimum and in any event, be remanded to the Tax Court for the taking of additional evidence on the compensation issue as injected in the case by that tribunal, and particularly as to the reasonableness or not of the compensation.

2. The evidence of record shows that the payments

in question in reality constituted guaranteed distributions in the nature of annual dividends to the taxpayer's three controlling stockholder-payees in proportion to their stockholdings in the taxpayer during the taxable years involved, as contended by the Commissioner in the Tax Court. The payments were made pursuant to the payment agreements of 1931 and 1944 between the taxpayer and one of its controlling stockholders, Maltby, and were payable thereunder monthly and/or quarterly to the three controlling stockholders in proportion to their stockholdings in the taxpayer (except in the case of Frank Dupar if his and not his associates' holdings are only to be taken into consideration). The evidence specifically shows that Dupar insisted upon receiving a guaranteed sum of money to come to him from the taxpayer each year, and therefore the other two controlling stockholders likewise decided to take annual sums from the taxpayer in proportion to their stockholdings. This arrangement was thereupon given effect by them and each thereafter received his or its payments from the taxpayer monthly and/or quarterly accordingly. The authorities cited hereinafter hold that such distributions of corporate earnings and profits constitute dividends — particularly to stockholder-distributees wholly controlling the corporation, as here—whether or not the formalities of a dividend declaration have been observed, the distributions are recorded on the corporation's books or made in proportion to the stockholdings, or some of the stockholders do not participate in the resulting benefits.

Nor did the payments in question in fact constitute compensation for services actually rendered by the

taxpayer's controlling stockholder-payees — Maltby (represented by Thurston), PCI (represented by Schmidt), and Frank A. Dupar (representing himself)—during the taxable years involved. The record shows that, contrary to the Tax Court's holding, controlling stockholder-payee PCI (represented by Schmidt) rendered no services in the negotiations conducted by Thurston and Dupar in arriving at the lease extension agreement of 1944, as the Tax Court itself found. It also shows that the above-mentioned payees or their officers and representatives received regular annual salaries from the taxpayer for their services during the life of the original lease of 1931 and its renewal in 1944. Nor does the record contain any corporate resolutions of the taxpayer providing for the payments in question as additional compensation for services of the stockholder-payees, over and above their or their officers' and representatives' regular salaries received annually from the taxpayer. Further, there is no evidence to show or even to indicate that such regular salaries were not adequate to compensate the payees for whatever services they actually performed for the taxpayer in connection with the operation of the hotel. In any event, the evidence clearly shows that the disputed payments were determined and made in proportion to the payees' stockholdings in the taxpayer, as already shown, and hence there is no basis in this record for the Tax Court's holding that the payments constituted deductible allowances for compensation for services, instead of nondeductible distributions of profits as determined and contended in the Tax Court by the Commissioner.

3. Assuming that the payments in question constituted compensation, as held by the Tax Court, they are nevertheless not shown by the record to have constituted *reasonable* compensation as they must be in order to be deductible under the pertinent statute. The Tax Court's holding to the contrary is not supported by the evidence or record, substantial or otherwise, and is therefore clearly erroneous and should properly be reversed upon review by this Court. The record shows that one-fourth of the taxpayer's annual payments in question was made to one stockholder-corporation which concededly rendered no services to the taxpayer, as the Tax Court itself found; one-half of each annual payment was paid to another stockholder-corporation whose only claim to rendering services to the taxpayer was through its president who, at the same time, was the president of the taxpayer from which he regularly received an annual salary; and finally the remaining one-fourth of such payments was paid annually to Frank Dupar who was the secretary of the taxpayer and likewise receiving an annual salary from the latter during the taxable years involved as well as back to 1931. There is no showing in this record of what would constitute a reasonable allowance for compensation for alleged services rendered by the stockholder-payees, a matter which can be determined only on the basis of a showing of the particular services actually rendered by them. The Tax Court did not specify, nor does the record disclose, the precise nature of the alleged services rendered to the taxpayer by each of the controlling stockholder-payees for which the payments in question allegedly constituted compensation. Accordingly, there

is no basis in this record for the Tax Court's gratuitous holding that the payments in question constituted even compensation for services, much less a "not unreasonable" compensation within the meaning of and deductible under the applicable statute and Regulations, as erroneously held by the Tax Court.

ARGUMENT

I

The Tax Court Improperly Decided the Case on a Ground Not in Issue and on Which the Commissioner Was Given No Opportunity to Present Evidence or Argument

The sole issue injected and decided by the Tax Court in this case was not pleaded, raised or argued by the taxpayer below, as the Tax Court pointed out and conceded (R. 45-46), nor indeed was the Commissioner afforded any opportunity in the Tax Court to present evidence or argument in respect thereto (R. 49-53).

Briefly, as already pointed out, the taxpayer whose stock was owned 50% by Maltby, 25% by PCI, and 25% by Frank A. Dupar and his associates, was organized in 1931 to become the operating company for the Multomah Hotel, Portland, Oregon, which was leased in that year to Maltby (with PCI and Frank Dupar as interested parties) which in turn assigned the lease to the taxpayer in that year. The Multnomah Hotel, thus leased by the taxpayer, was to be serviced by Western, a hotel service organization whose stock was also owned 50% by Maltby, 25% by PCI, and 25% by Frank A. Dupar. At the time of the execution of the original hotel lease in 1931 and again in 1944

when the taxpayer entered into the lease-extension agreement directly with the lessor, a separate agreement was executed under which the taxpayer was to make payments to Maltby, PCI and Dupar totaling $2,500 a month, or $30,000 a year.[6] (R. 92-96.)

The question here presented is as to the deductibility from the taxpayer's gross income of the sum of $30,000 which was paid annually by the taxpayer to its three controlling stockholders during each of the taxable years 1948-1949. In the Tax Court, the only issue pleaded, argued and briefed by the parties was whether these payments represented "rentals" deductible as business expense, under the provisions of Section 23(a)(1)(A) of the Internal Revenue Code of 1939, *supra,* as contended by the taxpayer (R. 6-7, 45-46), or whether they in reality constituted nondeductible distributions of profits in the nature of guaranteed dividends to the three controlling stockholders of the taxpayer, as determined and contended in the Tax Court by the Commissioner (R. 46). As to this question, the Tax Court, overruling the Commissioner's determination and holding that the payments in question did not constitute rentals as claimed

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[6] At the time of the lease extension agreement made in 1944 and during the taxable years 1948-1949, Thurston was the president and a member of the board of directors of the taxpayer, Maltby and Western; Frank A. Dupar was the secretary and a member of the board of directors of the taxpayer, vice-president and a member of the board of directors of Maltby, and the secretary and a member of the board of directors of Western. (R. 33-38.) Thurston and Dupar each received annual compensation from the taxpayer (R. 19-20) and from Western (R. 21-22), but not from Maltby (R. 18-19). As officers of the taxpayer, Thurston (president) received $10,200 a year during the period 1944-1949, and Dupar (secretary) received $4,500 a year during the same period. (R. 19-20.)

by the taxpayer (R. 45-46),[7] thereupon proceeded on its own initiative to consider the payments anew and, as indicated above, without affording the Commissioner any opportunity to present evidence or argument thereon and/or without solicitation on the part of the taxpayer, held that regardless of whatever name the taxpayer called the amounts sought to be deducted, "they were compensation for services rendered in the ordinary course of petitioner's business within the meaning of Section 23(a)(1)(A)," that "such compensation is not unreasonable," and therefore it is deductible by the taxpayer for the taxable years involved under that section of the statute (R. 47-48). In these circumstances, the Commissioner, taken by surprise and in the absence of any opportunity to present evidence or arguments in respect of this new issue thus injected for the first time in the case by the Tax Court, filed a motion to vacate and review the Tax Court's decision by the full court, under the provisions of Section 7460(b) of the Internal Revenue Code of 1954, and also an amendment thereto, on the grounds, among other things, that the decision is in conflict with numerous other decisions of the Tax Court wherein it had refused to consider issues not raised by the pleadings, both of which, motion and amendment, were denied by the Tax Court without giving reasons therefor. (R. 49-53.)

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[7] The Tax Court so held "even though so designated [as rentals by the parties themselves] in written contracts between the three [controlling stockholder] payees and petitioner" (R. 46, 69, 70, 83, 94, 96), and even though the taxpayer itself sought to limit the issue to the sole question as to whether or not the payments in question were properly deductible for the taxable years involved "as rentals" within the meaning of Section 23(a)(1)(A) of the 1939 Code (R. 45-46).

In the light of the foregoing, we submit that the Tax Court's action in deciding the case on a ground newly-raised by itself but neither pleaded, contended for nor argued by the taxpayer was not only most unusual, but also—in failing to give the Commissioner an opportunity to meet the newly-injected issue with evidence and argument—was erroneous as a matter of law, if indeed not arbitrary and capricious. See *Standard Galvanizing Co.* v. *Commissioner,* 202 F. 2d 736 (C.A. 7th), where the court in a comparable situation stated (p. 739):

> This question of negligence on the part of Brightly was not even suggested in the pleadings before the Tax Court, nor was there any stipulation of facts warranting such a finding. * * * We may assume that had the question of negligence been raised in the pleadings before the Tax Court there would have been evidence by which the question could have been accurately determined. In the absence of such an issue in the pleadings and of evidence on the issue, it was error for the Tax Court to raise the question * * *.

To the same effect, see the Tax Court's own decisions as cited by the Commissioner (R. 50) in his motion to vacate and review opinion by the full court and amendment thereto (R. 49-53).

In any event, we submit (and will establish below) that the record fails to support the Tax Court's conclusion (R. 47-48) that the taxpayer's payments to its three controlling stockholder-payees during the taxable years involved constituted compensation for services rendered by them and that the amounts thereof were "reasonable" as required in order to be deductible

under the provisions of Section 23(a)(1)(A); that the evidence fully supports a reversal of the Tax Court's decision as being unsupported by the record and therefore clearly erroneous, and that a remand to the Tax Court should therefore not be necessary. If, however, this court should not agree with our view that the evidence of record is thus conclusive, we submit that, under the above procedural argument, the case should be remanded to the Tax Court for the taking of additional evidence on the compensation issue as injected by that tribunal, and particularly as to the reasonableness of the compensation. In such event, the compensation issue should, we respectfully submit, be directed by this Court to be decided by that tribunal upon remand only after the Commissioner shall have had full opportunity to present evidence, arguments and authorities on the issue—something the Tax Court summarily denied the Commissioner, taken by surprise, at the hearing of the case. (R. 49-53.)

As to our contention that the evidence of record supports a reversal of the Tax Court's decision to the end that a remand to the Tax Court should not be deemed necessary, we submit the following in respect of the new issue involving compensation and the reasonableness or not thereof.

II

The Payments in Question Did Not Constitute Compensation for Services Rendered by the Taxpayer's Three Controlling Stockholders During the Taxable Years Involved, But Were in Reality Distributions in the Nature of Guaranteed Annual Dividends to Such Stockholders in Proportion to Their Stockholdings in the Taxpayer

We submit that (a) the Tax Court's conclusion that the disputed payments made by the taxpayer to its three

controlling stockholders during the taxable years involved represented compensation for services actually rendered by them during those years within the meaning of Section 23(a)(1)(A) is not supported by the evidence and is therefore clearly erroneous, and (b) such payments in reality constituted nothing more or less than distributions in the nature of guaranteed annual dividends to such stockholders in proportion to their stockholdings in the taxpayer corporation.

It will be noted that the Tax Court concluded, on the basis of its findings, that none of these various transactions—except the original lease of 1931 and the renewal thereof in 1944, as negotiated by the three (only two with respect to the 1944 renewal) stockholder-payees who controlled the taxpayer through a voting trust arrangement (R. 26)—here involved was arrived at on an am's length basis, and therefore each must be closely scrutinized as to whether the disputed payments constituted "other payments required to be made as a condition to the continued use or possession" of the hotel premises, within the meaning of Section 23(a)(1)(A) of the 1939 Code. Upon so doing, the Tax Court arrived at the conclusion that regardless of whatever the taxpayer called the payments in question, they were nevertheless compensation for services rendered by the payees in the ordinary course of the taxpayer's business during the taxable years involved, within the meaning of that Section (R. 47-48). So scrutinizing the same transactions referred to by the Tax Court, however, we fail to find any substantial evidence in this record—and the Tax Court pointed out substantially none (R. 46-48)—to support its conclusion thus arrived at. Rather, substantially all the evidence of record clearly points to the conclusion that the payments in question

constituted distributions in the nature of guaranteed annual dividends to the taxpayer's three controlling stockholders [8] in proportion to their stockholdings in the taxpayer, as contended by the Commissioner (R. 46). Hence, we take up the latter point first.

A. *The payments in question constituted distributions in the nature of guaranteed annual dividends to the taxpayer's three controlling stockholders in proportion to their stockholdings in the taxpayer.*

The record shows, significantly, that the payments made during the taxable years under the second payment agreement dated February 3, 1944 (R. 92, Ex. 5) were made pursuant to an agreement between the taxpayer and one of its controlling stockholders, Maltby, represented by Thurston, and were payable, as under the previous agreement of 1931 (R. 42-43), in the total sum of $2,500 a month ($30,000 annually) at the rate of 50% to Maltby, and 25% to each PCI and Dupar (R. 44, 92-97). Moreover, in 1944, when the second payment agreement was executed (R. 44), the taxpayer's stock was owned, through a voting trust, 50% by Maltby, 25% by PCI, and 25% by Dupar and his brother (R. 26). Under the voting trust, the taxpayer's stock was votable by Thurston (president of the taxpayer and also of both Maltby and Western) (R. 18-21), Dupar (secretary of the taxpayer and Western and also vice-president of Maltby) (R. 18-21), and F. M. Kenney (vice-president of the taxpayer and Western and also president of PCI) (R. 18-21) in be-

[8] The taxpayer's three controlling stockholders referred to were Maltby (represented by Thurston) and PCI (represented by P. G. Schmidt), and the individual stockholder, F. A. Dupar, representing himself (R. 46).

half of PCI, in that order (R. 40).[9] In these circumstances, it is clear that the payments made by the taxpayer under the 1944 agreement during the taxable years involved were made to its principal stockholders, who were at all times in control of the taxpayer corporation, in proportion to their stockholdings in the taxpayer—except as to Dupar's individual ownership [10]—as the evidence amply shows (R. 105-106, 114-115, 118, 120, 130-131, 137, 141).

In this connection, Dupar testified, among other things, that since he had been instrumental in obtaining the taxpayer's 1931 lease and the lease-extension agreement of 1944, he therefore "wanted a guaranteed sum of money to come from the [taxpayer] corporation" to him each year thereafter (R. 114-115), and that when he insisted upon thus receiving such annual income from the taxpayer, Maltby and PCI likewise "decided to take some, too" based upon "the proportions determined by [their] stockholdings" in the taxpayer (R. 118, 120). Moreover, both Dupar and Thurston categorically testified that the chief reason for the payment agreement was to obtain a portion of the taxpayer's profits before they were all spent on the rehabilitation and maintenance of the hotel (Dupar, R. 105-108, 114-115; Thurston, R. 130-131, 141). Accordingly, it is clear, we submit, that this, without more, plainly shows that the payments in question constituted distributions of the taxpayer's

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[9] Western, which was to furnish general supervisory and hotel service to the Multnomah Hotel (R. 28, 110-111, 141-142), was owned 50% by Maltby, 25% by PCI and 25% by Frank Dupar (R. 29).

[10] It is immaterial that Dupar's payments received from the taxpayer during the taxable years involved were not in proportion to his individual stockholdings in the taxpayer. (See cases cited, *infra*.)

profits in the nature of guaranteed annual dividends to its controlling stockholder-payees in proportion to their stockholdings in the taxpayer, and therefore taxable income in each of the taxable years in which received by them, as the Commissioner correctly contended in the Tax Court (R. 46). *Auerback Shoe Co.* v. *Commissioner,* 21 T.C. 191, affirmed, 216 F. 2d 693 (C.A. 1st); *United States* v. *Currier Lumber Co.,* 70 F. Supp. 219, 221 (Mass.), affirmed, 166 F. 2d 346 (C.A. 1st); *Chesbro* v. *Commissioner,* 21 T.C. 123, 129, affirmed, *per curiam,* 225 F. 2d 674 (C.A. 2d), certiorari denied, 350 U.S. 995; *United States* v. *E. Regensburg & Sons,* 221 F. 2d 336 (C.A. 2d), certiorari denied, 350 U.S. 842; *Regensburg* v. *Commissioner,* 144 F. 2d 41, 44 (C.A. 2d), certiorari denied, 323 U.S. 783; *Kahn* v. *Commissioner,* 210 F. 2d 247 (C.A. 3d), certiorari denied, 347 U.S. 967; *Paramount-Richards Th.* v. *Commissioner* 153 F. 2d 602, 604 (C. A. 5th); *Davis* v. *United States,* 226 F. 2d 331, 334-335 (C.A. 6th), certiorari denied, 350 U.S. 965, rehearing denied, 351 U.S. 915; *United States* v. *Jolly* (W. D. Tenn.), decided July 15, 1954 (1955 P-H, par. 72,958), affirmed *per curiam,* 229 F. 2d 180 (C.A. 6th), certiorari denied, 351 U.S. 963, rehearing denied, 352 U.S. 860; *Chattanooga Sav. Bank* v. *Brewer,* 17 F. 2d 79 (C.A. 6th), certiorari denied, 274 U.S. 751; *United States* v. *Rosenblum* (S.D. Ind.), decided August 18, 1948 (38 A.F.T.R. 1607, 1610), affirmed, 176 F. 2d 321 (C.A. 7th); *Hadley* v. *Commissioner,* 36 F. 2d 543, 544 (C.A. D.C.); *Christopher* v. *Burnet,* 55 F. 2d 527, 528 (C.A. D.C.). Moreover, the courts held, variously, in the above cases that corporate earnings and profits may constitute dividends—particularly to stockholder-distributees wholly controlling and dominating the corporation, as here—whether or not the formalities of a

dividend declaration are observed, the distributions are recorded on the corporate books or made in proportion to the stockholdings, or some of the stockholders do not participate in the resulting benefits.[11]

Nor, in any event, were the payments in question "rentals", as contended by the taxpayer in the Tax Court (R. 45-46) and properly overruled by the Tax Court (R. 46). This is made clear by the facts of record which show conclusively that the only rentals involved in the case are the "minimum fixed monthly rental of $7,000 per month", as provided by the terms of the original lease of 1931 (R. 40-41, 70), and the increased monthly fixed rental of $8,500 a month as provided by the lease-extension agreement of 1944 (R. 44, 83), plus designated percentages of the taxpayer's annual gross revenues as provided by each of those lease agreements (R. 40, 69-70, 82-83), all of which were paid by the taxpayer directly to the lessor and had nothing to do with the payments here in question.

B. *The payments in question did not in fact constitute compensation for services actually rendered by the taxpayer's controlling stockholders during the taxable years involved.*

The Tax Court, without specfically specifying the personal services purportedly rendered by the three controlling stockholders (two of which were corporations) for which, it held, they received the disputed payments as extra compensation—over and above the regular salaries paid by the taxpayer to them or to persons who were their representatives as well as tax-

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[11] The record shows that Dupar never shared any of his payments received from the taxpayer with his stockholder associates (R. 105).

payer's (R. 19-20)—in carrying on the taxpayer's trade or business during the taxable years involved, within the meaning of Section 23(a)(1)(A), apparently had in mind both (1) the services *required* of Maltby and/or Western in the taxpayer's operation of the Multnomah Hotel pursuant to the terms of the original lease and the renewal thereof extended to mid-1961 (R. 40-44), and (2) the efforts of Thurston (representing Maltby), Schmidt (acting for PCI), and Dupar (for himself) in negotiating the original lease of 1931 (R. 42), and of Thurston (representing Maltby) and Dupar—without Schmidt (acting for PCI) (R. 44-45)—in negotiating the renewal thereof in 1944 (R. 43-44). Thus, the Tax Court stated (R. 46) that the basis for the taxpayer's payments in question was the services rendered "by the three payees" (Maltby, PCI and Dupar) prior to the execution of the original lease in 1931, and for services rendered prior to the execution of the renewal lease extension agreement in 1944, and also "for services to be rendered thereafter during the term of the lease and its renewal" extending to mid-1961. The record shows, however, that payee PCI (represented by Schmidt) rendered no services in the negotiations conducted by Thurston (representing Maltby) and Dupar leading up to and entering into the lease extension agreement of 1944 (R. 43-44, 45), and further that the payees or persons who were their representatives as well as taxpayer's received regular salaries from the taxpayer for their services during the life of the 1931 original lease and its renewal extension in 1944 (R. 19-20). Nor does the record contain any corporate resolutions of the taxpayer providing for

the payments in question as additional compensation for services of the stockholder-payees, over and above the regular salaries received annually from the taxpayer by them or persons who were their representatives as well as taxpayer's. Neither, contrary to the Tax Court's holding (R. 47-48), does it show that any of the payments in question were in fact made as "compensation" for services rendered by the stockholder-payees prior to the execution of the original and extended leases in 1931 and 1944, respectively, or thereafter for that matter (R. 46), as is evidenced by the fact that, insofar as this record shows, they or persons who were their representatives as well as taxpayer's received regular annual salaries from the the taxpayer for *all* their services actually rendered to it during both taxable years involved as well as prior thereto (R. 19-20).

The record further shows that the terms of both the original lease of 1931 and likewise the lease-extension agreement of 1944 required that "the majority of the personnel" of the taxpayer was to be "the same as that of" Maltby and/or Western (R. 41, 44, 92, 94-95), but it contains no clear or satisfactory explanation of what was meant by that provision.[12] Western, organized in 1930 as a hotel service organization to render general services to all hotels for a consideration, and whose stock ownership was the same as the taxpayer's—except for Dupar's personal ownership (R. 26, 28-29)—supplied supervisory and operational services to the taxpayer but

[12] The implication is, of course, that the taxpayer was to have the same officers and personnel as Maltby and Western had because they were experienced owners and operators of long standing, with wide interests in various hotel businesses. (R. 26-40, 48, 62.)

was adequately paid for those services by the taxpayer (R. 139-142). A majority of the officers of the taxpayer were at all times the same as those of Maltby and/or Western, including, in 1931, Thurston, Schmidt and Dupar and, in 1944, Thurston (of Maltby and Western), F. M. Kenney (of PCI and Western), and Dupar (of Maltby and Western). (R. 18-23, 33-40.) All of those individuals, (except Kenney), however, received substantial annual salaries as officers of the taxpayer during its first year of incorporation and operation (1931) and thereafter (except Schmidt) through the taxable years here involved. (R. 19-20.) Nor is there any evidence in this record to show or indicate that their salaries were not adequate to compensate them for whatever services they performed for the taxpayer in connection with the operation of the hotel during the earlier years and/or the taxable years. Hence, there is no basis in the record to support the Tax Court's gratuitous conclusion that the payments in question—in addition to the regular annual salaries paid by the taxpayer—were for services rendered by the three stockholder-payees not only prior to the execution of the original lease in 1931 and the renewal thereof in 1944 but also "for services to be rendered thereafter [by them] during the term of the lease and its renewal" (R. 46), running to mid-1961 (R. 44).

Moreover, it is clear that if the negotiations leading up to the execution of the original lease agreement in 1931 and the renewal lease-extension agreement of 1944 constituted services rendered to the taxpayer by the controlling stockholder-payees, as the Tax Court held (R. 46, 48), then such payees have long since

been fully compensated therefor, certainly long before the taxable years here involved. This is shown by the record which discloses that during the approximate 10-month period prior to the execution of the original lease in 1931, Thurston (president of and representing Maltby), Schmidt (trustee of and representing PCI) and Dupar (representing himself) conducted negotiations which resulted in the acquisition of the original hotel lease of June 17, 1931, by Maltby and shortly thereafter (June 30, 1931) assigned by it to the taxpayer (R. 40-42) which, as pointed out, was a corporation organized for the express purpose of becoming the operating company for the hotel (R. 41). The record also shows that Thurston and Dupar carried on the negotiations for the lease-extension agreement obtained in 1944 (R. 43-44) while they were both officers of Maltby and Western (R. 18, 21) and also, at the same time, salaried officers of the taxpayer (R. 19). And again, there is no evidence in the record to show or even indicate that their services in negotiating the lease-extension agreement of 1944 were performed for or in behalf of anyone other than the taxpayer, nor, since neither of them ever actually "did * * * work full time for the [taxpayer] petitioner" (R. 138-139), that their regular salaries received as such from the taxpayer annually (R. 19) were not fully adequate to compensate them for the *part-time* services which they only rendered for the taxpayer.[13] Finally, contrary to the Tax Court's

[13] Both Thurston and Dupar had wide interests in various hotel organizations, as pointed out, and not only did they never work full time for the taxpayer but also, as Thurston testified (R. 139): "We don't work full time for any of them [hotels] excepting when we are called upon and have work to be done."

contradictory finding that the basis for the alleged compensatory payments here in question was "services rendered by *the three payees*" (italics supplied) (Maltby, represented by Thurston; PCI, represented by Schmidt, and Dupar, for himself) prior to the execution of the original and renewal extension lease agreement of 1931 and 1944, respectively (R. 46, 48), its findings also show, as we have indicated above, that Schmidt (trustee of PCI) as far as the 1944 lease extension agreement is concerned neither participated in these negotiations nor rendered any services for or in behalf of the taxpayer in connection therewith.[14]

In the 1944 payment agreement (R. 92-97, Ex. 5), pursuant to which the disputed amounts were paid by the taxpayer to its controlling stockholder-payees during the taxable years here involved, reference is made to the "assurance" of Maltby to the lessor that "the majority of the personnel" of the taxpayer would be the same as that of Maltby and/or Western, and also the agreement of Maltby and Western "to co-operate" with the taxpayer in the successful operation of the hotel and to give it such assistance as they properly could (R. 94-96). It is clear, however, that such *assurance* of Maltby and the *cooperation* with the taxpayer, as agreed to by Maltby and Western, can hardly be properly construed as services rendered to the taxpayer then or later, nor does the extension agreement of 1944 provide or indicate that the payments here in question were to be made to compensate

[14] In this connection, the Tax Court found (R. 43-44, 45) in respect of the lease renewal negotiations in 1944 that Schmidt, as trustee for PCI, had "taken no part therein," and that he "did not in fact aid in the procurement of the [lease] extension agreement" in that year.

for any services performed or to be performed by the taxpayer's controlling stockholder-payees in relation to the above-mentioned items. (R. 94-95.) Those items listed as "considerations" clearly did not represent and could not have constituted consideration for the agreement for neither Maltby nor Western is shown by this record to have suffered any detriment by giving their assurance that "the majority of the personnel" of the taxpayer would be the same as their own personnel and/or by agreeing to cooperate with the taxpayer in the operation of the hotel (R. 94, 95) for which, as shown, their officers and representatives who were also officers of taxpayer regularly received annual salaries from the taxpayer (R. 19-20). Such assurances and promised cooperation, very clearly, were merely part of the original plan of the interested parties designed for the success of the new hotel venture and no more than what was expected to result in profits to Maltby, PCI and Dupar as controlling stockholders of the taxpayer in the operation of the hotel. (R. 128-129.) The record shows that such obligation of Western, specifically organized to render supervisory and general management services, etc., to all hotels (R. 28), was not considered detrimental or prejudicial to it in any way with respect to the development and operation of the taxpayer's hotel property but rather, as Dupar testified (R. 110), "I would figure that was a compliment." Indeed, rather than being detrimental to Maltby and/or Western, it was clearly highly beneficial for them to have the majority of their officers and personnel to act as officers and personnel of the taxpayer, particularly in view of the fact that Maltby, as the largest controlling

stockholder of the taxpayer (R. 26), could, and in fact did, thereby select its own officers (R. 18-19, 21-22, 33-35, 37-38) to act in key positions as the taxpayer's officers (R. 19-20, 35-36).

Moreover, the 1944 payment agreement contains further features tending to negative the Tax Court's conclusion (R. 47-48) that the payments made to the taxpayer's controlling stockholders represented compensation for services. Thus, the record shows that PCI (represented by Schmidt) was one of the payees (R. 44, 46) but was neither a party to the agreement (R. 92) nor, according to the provisions of the agreement itself, was it to furnish, nor did it furnish, any of the alleged considerations therefor (R. 94-96). Neither was Dupar, though one of the payees under the agreement (R. 42, 46), a party to the payment agreement [15] and none of the alleged considerations are shown to have moved from him to the taxpayer for the payments here in controversy [16] (R. 43-44). Finally, though Western was a party to the payment agreement (R. 92) and is said to have furnished some of the alleged consideration therefor (R. 94-96), yet the record shows that it was at all times otherwise

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[15] Both PCI and Dupar merely gave their approval to the agreement. (R. 97.) This was done pursuant to the provisions of Paragraph 1 thereof. (R. 93-94.)

[16] Since Dupar's personal participation in the lease extension negotiations had taken place during the early part of 1944, it is a little difficult to see how the taxpayer's payments in question, made during the taxable years 1948 and 1949 pursuant to the 1944 payment agreement, can qualify currently as deductions for compensation for the taxable years involved for services actually rendered several years earlier. Services rendered in 1944 can hardly be projected several years thence to 1948 and 1949 for compensation deduction purposes especially when there had been payments under the 1944 agreement during the intervening years.

fully compensated for its services rendered to and in behalf of the taxpayer beginning with its corporate inception in 1931 (R. 29, 110-111) and further that it was not a valid payee except indirectly in the sense that its stockholders (Maltby, PCI and Frank Dupar (R. 28-29)) were payees (R. 44, 46).

The evidence of record further fails to support the Tax Court's conclusion (R. 47-48) that the disputed payments made by the taxpayer to Maltby, PCI and Dupar during the taxable years constituted compensation for personal services actually rendered to the taxpayer by the three controlling stockholders in the ordinary course of its business during those years. Certainly the testimony of the two principal witnesses (Thurston annd Dupar), who were also officers of the taxpayer, offers little, if any, support therefor. As the Tax Court stated in its opinion (R. 47), Maltby (represented by Thurston), PCI (represented by Schmidt) and Dupar representing himself "were the parents responsible for its [taxpayer's] birth" in 1931. The record shows that these parties had joined together in 1930 in organizing Western, a general hotel service organization, as pointed out, in order to eliminate competition among themselves and thereafter to act in concert for their mutual benefit in their various hotel businesses (R. 28-29,) and thereupon in 1931 they planned to obtain a lease on the Multnomah Hotel in Portland, Oregon, and to assign the lease to a new corporation (taxpayer) to be organized for the operation of the hotel which, in turn, was to be supervised generally and serviced by Western (R. 40-42). Upon their obtaining the lease in Maltby's name in 1931 (R. 99), it was shortly thereafter assigned by Maltby to the

taxpayer in that year (R. 41-42), and at the same time a separate agreement was executed under which Maltby, PCI and Dupar (the taxpayer's principal stockholders, as previously shown (R. 26)) were to receive payments from the taxpayer in the total sum of $2,500 a month, aggregating $30,000 a year (R. 42-43).

Frank Dupar, the principal motivating factor in respect of the payment agreement of 1931 (R. 42, 101-102), testified that he considered that he, "just a minority stockholder" of the taxpayer, was entitled to something for having done what he called "all the work" in negotiating the lease (R. 102), and that, as a minority stockholder in the taxpayer, he feared that Maltby and PCI "would wish to retain [taxpayer's] earnings to take care of the rehabilitation [of the hotel] or other purposes", and therefore he "wanted a guaranteed sum of money to come from the corporation [taxpayer]" to him "each year" (R. 114-115). Upon his insistence that he receive something *each year* for the part he played in the negotiations for the original lease in 1931, Maltby and PCI likewise decided to take something too, that is, annual earnings from the taxpayer (R. 42-43, 123-124), based on "the proportions determined by [their] stockholdings" in the taxpayer (R. 118), "and this proportion of thirty thousand [dollars annually, paid at the rate of $2,500 a month by the taxpayer] was again based on [the] stockholdings" of Maltby and PCI in the taxpayer, but not on Dupar's minority stockholdings therein (R. 120).[17] Thurston, representing Maltby, testified that he believed that the payment

[17] Frank Dupar's share of 25% was not based on his stockholdings in the taxpayer for, as pointed out, he himself did not own a full 25% share thereof (R. 26, 123-124). However, he and his associates did own a full 25% share in taxpayer.

agreement "was predicated a great deal upon the services rendered." (R. 137.) As to whether or not it was true that the 50% paid Maltby and the 25% paid Schmidt, as trustee for PCI, "was coincidentally proportionate to the stockholdings of those two in the petitioner [taxpayer]", Thurston, without denying such proportionate payments, stated that "The facts are there to show for themselves" in connection therewith. (R. 137.)[18] Moreover, both Dupar and Thurston categorically testified that the principal reason for the payment agreement was for the purpose of obtaining a portion of the taxpayer's profits before they were entirely spent on the rehabilitation and/or maintenance of the hotel (Dupar, R. 105-108, 114-115; Thurston, R. 130-131, 147). In harmony with the foregoing evidence, the Tax Court found as facts that, over and above the $625 monthly payment ($7,500 a year) received by Dupar from the taxpayer (R. 42-43), "The remainder [$1875 a month, or $22,500 a year], it was agreed [by taxpayer's controlling stockholders Maltby, PCI and Dupar], would be divided between PCI and Maltby *in proportion to their respective stock holdings in* [*taxpayer*] *petitioner*" (R .43). (Italics supplied.)

The record further discloses that the taxpayer's controlling stockholder payees of the sums in question failed to remember and, in any event, were unable to explain how and/or on what basis the amounts of the disputed payments were arrived at and determined.

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[18] Since the facts of record show that the taxpayer's $2500 monthly payments, aggregating $30,000 a year, were in fact made to Maltby and PCI in proportion to their stockholdings in the taxpayer, it is clear that witness Thurston's reliance on the facts as speaking for themselves, thus concedes the proportionate payments on the basis of the payees' (except Dupar's) stockholdings in the taxpayer.

(R. 121-123, 136-138.) Thus, Thurston, when asked whether or not the payments in question "represented a fair compensation for the services and liability and responsibility which was involved" (R. 131), testified (R. 131, 132) that—

> We felt that it did at that time.
>
> * * * * *
>
> We felt that it did. We recalled all of the work we had done in it, the speculation that was involved and the work that was staring us in the face in order to make it a successful enterprise; therefore, we felt it was a fair deal.

Dupar testified that when the lease was extended in 1944 and the new payment agreement (R. 92, Ex. 5) was executed, the parties thought that they "were entitled to something" for giving up a lower rent on the hotel for the remaining 2½ years of the original lease (R. 112-113), although Thurston testified that an extension of the lease was desirable and had been sought even earlier (R. 132-133). Dupar further testified that at that time the hotel had "very high" *net* earnings and was a successful venture (R. 108); there also was no longer any danger that *all* of the taxpayer's "future earnings would have to be plowed back [into the hotel] for repairs and maintenance", as was the condition existing back in 1931 (R. 119-120); and as to how the new payment agreement of 1944 was determined, "It was just a continuation of what we had before" (R. 121), and "We just extended it", that is, the original payment agreement of 1931 (R. 122-123). Thurston testified that the first agreement "had been carried on without any contest from anybody", and they thought

that they were just as much entitled to payments as previously, "and so we just didn't raise the question any further or go into any discussion as to any modification of it" (R. 133); and when he was asked why Maltby still received 50% of the payments after 1946 when it was no longer a party to the lease, he stated that Maltby "still had the same stockholdings" in the taxpayer (R. 125-126). Finally, Thurston at one point in his testimony referred to the payments in question as having been "lease rent" which constituted "dividends" received by taxpayer's controlling "stockholders * * * for a number of years" (R. 136),[19] and earlier he had testified in respect of the payments in question, totalling $30,000 a year, that "I don't know how you would refer to it unless it would be as a rental" (R. 134-135).

In view of the foregoing, it is clear that this case simply reflects control and domination of the taxpayer by its three principal stockholders. Those stockholders (Maltby, PCI and Dupar) were undoubtedly responsible for the taxpayer's success but it was *as stockholders* that they operated. The over-all picture seems clearly to be one whereby these controlling stockholders of the taxpayer required the taxpayer to make certain fixed annual payments to them, in proportion to their stockholdings, as the evidence shows, because one of those stockholders (Dupar), originally wanted, indeed insisted upon, an annual return on his investment from

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[19] Thurston, when asked whether there was a net profit earned by the taxpayer every year commencing with its incorporation in 1931, replied (R. 136) that—

> I believe there was a net profit, but it was all spent in the rehabilitation of the properties. I don't think any of *the stockholders got any dividends outside of this lease rent for a number of years.* (Italics supplied.)

this particular hotel venture of the taxpayer. Moreover, it is highly significant, we submit, that there was no allocation or attempted allocation of the payments according to the controlling stockholder-payees' alleged services rendered to the taxpayer but only in proportion to their (except Dupar's) [20] stockholdings in the taxpayer. For such services as were actually rendered to the taxpayer, the individuals (stockholder-officers) rendering the services clearly otherwise received adequate compensation as salaries from the taxpayer for all years involved insofar as this record shows. (R. 19-20.)

III

Assuming That the Payments in Question Constituted Compensation for Services Rendered by the Controlling Stockholders to the Taxpayer During the Taxable Years, They Are Not Shown by the Record to Have Constituted Reasonable Compensation Allowable as Deductions Under the Statute

The statute allows as deductions all ordinary and necessary business expenses paid or incurred during the taxable year, including "a reasonable allowance for salaries or other compensation for personal services actually rendered" to the taxpayer. Section 23(a)(1)(A) of the 1939 Code, *supra;* see also Section 29.23(a)-6(1)(a) and (3) of Treasury Regulations 111, *supra.* The Tax Court held that the $30,000 annual payments in question not only constituted compensation for services rendered to the taxpayer by its three controlling stockholders in the ordinary course of its business within the meaning of the statute but also that "such compensation is not unreasonable" and therefore is deductible

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[20] However, as pointed out, if Dupar's associates' stockholdings are included in his share the allocation as to him was also on the basis of stock ownership.

by the taxpayer for each of the taxable years involved (R. 47-48.) [21] We submit that, upon this record, the Tax Court's holding is not supported by the evidence or otherwise, and is therefore clearly erroneous and should properly be reversed upon review by this Court.

The record shows that the taxpayer, under the respective 1931 and 1944 payment agreements, made payments to its three controlling stockholders totalling $30,000 a year, or approximately $540,000 from 1931 through 1949 (the last taxable year involved, no such payments having been made during an undisclosed short portion of the first year (1931) when the taxpayer was organized. (R. 43.) The record further shows that (a) 25% of the taxpayer's annual payment in question, or $7,500, was made to a stockholder-corporation (PCI, represented by Schmidt) which concededly rendered no services to the taxpayer, as the Tax Court itself found (R. 44, 45), (b) 50% thereof, or $15,000, was paid to another stockholder-corporation (Maltby, represented by Thurston) whose only claim to have rendered services to the taxpayer was through its president (Thurston (R. 42-43, 44)), who at the same time was the president of the taxpayer from which he regu-

[21] The Tax Court stated that while the Commissioner contended that the taxpayer's $2,500 monthly payments (totalling $30,000 annually) to its three controlling stockholders were in excess of the true rental value of the hotel premises, yet "he makes no contention that they are excessive or unreasonable as compensation" for the taxable years involved. (R. 48.) Needless to say, no such contention was made or could have been made by the Commissioner below for the very obvious reason that the question whether the disputed payments constituted compensation, reasonable or otherwise, was not in issue in the Tax Court, nor would the Tax Court permit the Commissioner a further hearing, as requested (R. 49-53), in order to afford him an opportunity to present evidence and argument in respect of such new issue, as shown in Point I, *supra*.

larly received a substantial annual salary from 1931 through the last taxable year here involved (R. 19-20), and (c) the remaining 25% of the annual payment ($7,500) was paid to Dupar who was the secretary of the taxpayer and likewise receiving a regular annual salary from the taxpayer during all of those years (R. 19-20).

The taxpayer, of course, had the burden of proving that the payments in question constituted *reasonable* compensation for personal services actually rendered to it during the taxable years involved, but it did not even contend in the Tax Court that the disputed payments constituted compensation for services rendered it, nor did it raise the issue in the pleadings. It contended, rather, that the disputed payments constituted proper deductions as rentals paid by it during the taxable years (R. 45-46), as shown under Point I, *supra*. The Tax Court, however, as pointed out above, of its own initiative, gratuitously determined and held both that the payments constituted, not rentals (R. 46) but rather, compensation for services, and that "such compensation was not unreasonable" and therefore was deductible by the taxpayer for the taxable years involved (R. 47-48). This holding in respect of reasonableness is, of course, as vague, especially in the light of the evidence of record, as is its other holding that the payments constituted compensation for services rendered to the taxpayer.

It is clear that a reasonable allowance for compensation for services rendered within the meaning of the applicable statute and Regulations can be determined only on the basis of a showing of the particular services rendered and specifically what constitutes reasonable

compensation for such services. As pointed out under Point II (B), *supra,* the Tax Court did not specify, nor does the record disclose, the precise nature of the alleged services rendered to the taxpayer by each of its three controlling stockholder-payees for which the payments in question purportedly constituted compensation as erroneously held by the Tax Court. In these circumstances, it is clear that there is no possible basis in this record for the Tax Court's gratuitous determination and unsupported holding. (R. 47-48) that the payments in question constituted compensation for services at all, much less a "not unreasonable" compensation within the meaning of Section 23(a)(1)(A.

In view of the foregoing, we submit that the Tax Court's decision in respect of both compensation and the purported reasonableness thereof is wholly unsupported by the evidence of record, much less substantial evidence as is required in order to be sustainable; is therefore clearly erroneous; and should accordingly be reversed by this Court without remand to the Tax Court. *United States* v. *Gypsum,* 333 U.S. 364, 394-395, rehearing denied, 333 U.S. 869; Rule 52(a) of the Federal Rules of Civil Procedure. Moreover, since the record shows that the Tax Court decided this case on a basis neither pleaded nor argued by the taxpayer, and in respect of which the Commissioner was afforded no opportunity to present evidence and argument, it necessarily follows, we submit, that the conclusions reached by it as a matter of law have no foundation in the evidence, and that at a minimum and in any event, the case, if not reversed in favor of the Commissioner by this Court upon review, should be remanded to the Tax Court, to the end that the factual issues upon which

the Tax Court's erroneous decision turned may be adequately developed and corrected upon remand and rehearing below.

CONCLUSION

The decision of Tax Court is in all respects incorrect and not in accordance with law, and should therefore be reversed in favor of the Commissioner upon review by this Court, or, in any event, remanded to the Tax Court for further and proper hearing in respect of the issue involved.

Respectfully submitted,

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